IN THE

Supreme Court of the United States

OCTOBER TERM, 1950.

No. 461

IN THE MATTER OF

FEDERAL FACILITIES REALTY TRUST, A COMMON LAW TRUST, AND NATIONAL REALTY TRUST, A COMMON LAW TRUST,

Debtors.

STACY C. MOSSER, SUCCESSOR TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST, AND JOHN W. GUILD, INDENTURE TRUSTEE, ETC.,

Petitioners,

vs.

PAUL E. DARROW, FORMER TRUSTEE OF NATIONAL REALTY TRUST AND FEDERAL FACILITIES REALTY TRUST,

Respondent.

BRIEF FOR PETITIONERS.

CARL W. MULFINGER,
J. EDGAR KELLY,
STANLEY A. KAPLAN,
JACOB B. COURSHON,
Counsel for Petitioners.

THE GUNTHORP-WARREN PRINTING COMPANY, 215 WEST JACKSON, CHICAGO

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I.

THE OPINION IN THE COURT BELOW.

The opinion in the Court of Appeals for the Seventh Circuit is reported in 184 F. (2d) 1, and appears at pages 675-691 of the record.

II.

JURISDICTION.

Jurisdiction to review this case is based upon Section 1254 of the Judicial Code, as revised by the Act of June 25, 1948 (28 U. S. C. 1254), and Section 24 of the Bankruptcy Act, as amended by the Act of June 22, 1938 (11 U. S. C. 47).

III.

STATEMENT OF THE CASE.

In the early 1920's, Jacob Kulp was president and Myrtle Johnson secretary of Jacob Kulp & Company, Inc., an Illinois corporation, which organized, promoted and controlled twenty-six building corporations, the properties of most of which were leased to the United States Government for post office use (R. 167, 181). These buildings were financed by the sale of mortgage bonds to the public, while the capital stock in each corporation was issued to Jacob Kulp, individually. In addition, Jacob Kulp owned in fee certain premises in Los Angeles, upon which a building was constructed for post office use. These twenty-seven properties were subject to large first mortgage bond issues and, in some instances, second mortgage bond issues as well (R. 152-153, 167-168). In 1929, the promoters of these building corporations, being confronted with a decrease in rents resulting from the cancellation and modification of the leases with the government and a general decrease in other rents, established two common law trusts and attempted to persuade the holders of bonds issued by these various building corporations to exchange their securities for securities issued by one or the other of these two trusts (R. 159, 181).

The two common law trusts so created are known as Federal Facilities Realty Trust, which was created by declaration of trust dated September 10, 1929 (hereinafter referred to as Federal) and National Realty Trust, which was created by declaration of trust dated July 2, 1930 (hereinafter referred to as National). The original trustees of each trust were Jacob Kulp, Lee H. Kulp, and Myrtle Johnson. To Federal, Jacob Kulp transferred all of the capital stock of fourteen of the building corporations, in exchange for one hundred thousand shares of beneficial interest and three hundred thousand dollars, face value, collateral trust bonds issued by said trust. These collateral trust bonds were secured by an indenture of mortgage dated October 1, 1929, under which John W. Guild, as successor trustee, holds all of the capital stock of the fourteen building corporations as security (R. 293, 502). To National, Jacob Kulp transferred all of the stock of the other twelve building corporations, plus the fee in the Los Angeles property (which was later incorporated) in exchange for twenty thousand shares of beneficial interest in this trust (R. 181).

In July of 1933, as the result of an investigation by the Department of Justice, Jacob Kulp, Lee Kulp, and Myrtle Johnson resigned as trustees of Federal and National, and George H. Andresen and Harry R. Holden were named to succeed them (R. 8, 150). At the same time, Jacob Kulp delivered to Andresen, under a separate trust agreement, bonds issued by the various building corporations, as well as bonds and units of beneficial interest in the two trusts which he had in his possession at that time (R. 154-156). These securities will be discussed further on in this statement of the case.

These proceedings for the reorganization of Federal and National were filed in December, 1934; and upon the approval of the petitions, Paul E. Darrow was appointed

trustee of each trust, which position he held until he resigned on August 10, 1943, following a thorough financial investigation and report of his administration as trustee, made by Frederick B. Andrews pursuant to order of court entered January 19, 1942, on the application of the Securities and Exchange Commission (R. 37, 548). Stacy C. Mosser was appointed as successor trustee of each debtor on August 10, 1943 (R. 9, 38). Mosser continued to act as trustee of both National and Federal until October 17, 1950, at which time he was succeeded by Frank M. Whiston as trustee of National and, on December 1, 1950, Joseph Schwartz succeeded him as trustee of Federal.

On October 15, 1943, Darrow filed his final accounts as trustee of each trust; and Mosser, as successor trustee, the Securities and Exchange Commission, and Guild,* as successor trustee under the indenture securing the collateral trust bonds of Federal, filed objections to these accounts (R. 500-510). The final accounts of Darrow, and the objections thereto, were referred by the District Court to a special master (R. 146-148). The report of the special master sustained the objections to Darrow's accounts insofar as they sought to surcharge him with $43,447.46, being profits made by two of his employees who were permitted to trade in securities of the trusts consisting of bonds issued by the subsidiary corporations of the debtor trusts (R. 552-557).

The report of the special master was approved by the District Court, and the accounts of Darrow, as trustee, surcharged with said profits; pursuant to the recommendation of the special master, a ruling on all other objections to the trustee's accounts was reserved by the District Judge pending further proceedings (R. 577-585). From this order of the District Court, Darrow appealed and Guild filed a cross-appeal (R. 585-587, 595-596). The Court of Appeals for the Seventh Circuit reversed the order of

the District Court insofar as it surcharged Darrow's account with the profits made by his employees; in all other respects the order was affirmed (R. 675-691). No action was taken on the matters raised on the cross-appeal (R. 690-691).

The evidence presented to sustain the objections to Darrow's accounts disclosed that after his appointment as trustee, he occupied the former offices of the trusts and employed Jacob Kulp and Myrtle Johnson to assist him in his duties (R. 318). They were familiar with the business, having been in control of these trusts and corporations since their creation. Kulp and Johnson, at the time of Darrow's appointment, were operating, from the office of these trusts, Colonial Securities Company (hereinafter referred to as Colonial), a corporation wholly owned and controlled by them which dealt largely in the securities of these trusts (R. 188). They were also winding up the affairs of Jacob Kulp and Company, which was then in bankruptcy (R. 318).

Darrow, with full knowledge of the previous connections Kulp and Johnson had with these trusts and the various capacities in which they were then acting, employed Jacob Kulp to manage the buildings owned by the subsidiary corporations of each trust, and permitted him to have access to the books and records of the trusts and their subsidiaries (R. 199-200). Myrtle Johnson's duties were numerous. She had complete supervision of the trustee's office, access to all books and records, acted in behalf of the trustee when bondholders came to his office or made inquiry by telephone, advised the trustee on all phases of management, assisted him in the reorganization of the subsidiary corporations and, at times, fixed the prices the trusts or the subsidiary corporations should pay for bonds (R. 188, 190, 199-200, 202, 203, 206, 281-287, 319). For these services, Kulp was paid a salary of $300 a month and given

free use of an apartment worth $135 to $140 a month (R. 169, 182). Miss Johnson received a salary of $250 a month, and she and Kulp were permitted to continue to operate Colonial (R. 169, 182, 202-203). Except for dealing in securities associated with the trusts, Colonial was then practically in liquidation and doing little business (R. 150).

During the period of Darrow's administration, the debtor trusts and Colonial Securities Company occupied a common office which had two entrances, one marked Colonial and the other with the names of the debtor trusts, both of which opened into what appeared to be one large office (R. 151, 206, 538-539). Darrow and Colonial were listed under one telephone number, and the books of the trusts and Colonial were kept by the bookeeper employed by the trustee (R. 150, 152, 539). The cashier employed by Darrow also did work for Colonial, as did his stenographer (R. 153, 156). Miss Johnson occupied a private office in that portion of the suite occupied by the trustee, and bondholders coming to the office of the trustee were usually referred to her (R. 153).

While so employed, Miss Johnson and Kulp, individually, and in the name of Colonial, intercepted and purchased bonds brought into the trustee's office by bondholders seeking to sell them (R. 168, 513, 579). Miss Johnson and Kulp would purchase these bonds for less than Darrow was paying, and then sell them to Darrow or some outside investor at a profit. Darrow at all times had knowledge of these dealings and made no objection to them; in fact, he encouraged these activities by assuming the attitude that "it was not any of my business if an employee made a profit" and at times paid for bonds prior to delivery (R. 205, 295-296).

The largest single transaction involved the acquisition by Miss Johnson and Kulp of the substantial block of securities previously mentioned as the securities Kulp de-

livered to Andresen in July, 1933. These securities were divided into two lots and sold by order of the Superior Court of Cook County, Illinois, in the case of *Seligman* v. *Kulp* (R. 517). Lot I consisted of bonds of the various subsidiary corporations in the face amount of $199,000 (R. 518). Lot II consisted of $286,100 principal amount of Federal bonds secured by the indenture under which Guild is trustee, 62,358 units of beneficial interest of Federal, and 10,761.6 units of National (R. 518). These last mentioned securities are held in a safety deposit box pending the determination of the question of ownership by the District Court and are not involved in the surcharge which is the subject of this appeal (R. 557). The ultimate owner of these securities, however, will control sixty percent of the equity in Federal and more than fifty percent of its bonds, and twenty-five percent of the equity in National (R. 165, 292, 294).

All of the securities in both Lots I and II were purchased for the sum of $24,203.55. Prior to the consummation of this sale, Darrow delivered to Miss Johnson $12,447.55, which was the total of fifteen checks in varying amounts drawn on the bank accounts of National and Federal and six of their subsidiary corporations (R. 172). This amount, plus $11,756, which Miss Johnson borrowed from two other individuals, accounted for the entire purchase price. Miss Johnson delivered to Louis Goldman, one of the attorneys for petitioning creditors in these proceedings, the sum of $24,203.55 with instructions to arrange for the purchase of all of the securities in Lots I and II at the sale to be held in the *Seligman* case. Upon the consummation of the sale, Miss Johnson received all of the securities in Lot I from Goldman (R. 162). From the bonds so received, she gave Darrow bonds having a face value of $128,700 in exchange for the money he had given her; the balance of these bonds in the amount of $60,300 she sold to outside investors for $19,457.50, after giving bonds having a face value of $10,000 to the two individuals

from whom she had borrowed the $11,756.[1] These gifts were in the nature of a bonus, because the loans were repaid in cash from the $19,457.50 received from the sale of the bonds she retained (R. 522). The employees of the trustee thus realized a profit of $10,701.50 on this transaction; in addition, they claim to own the securities of these debtors in Lot II which remain in the safety deposit box rented in the name of Attorney Goldman (R. 162, 292, 294).

The total surcharge of $43,447.46 which the District Court assessed against Darrow was computed as follows:

Profits made by employees from sales direct to Darrow	$ 8,624.10
Profits made by employees from transactions with the public	24,121.86
Profits made by employees from securities purchased at a judicial sale and resold to the public	10,701.50
Total surcharge	$43,447.46

IV.

SPECIFICATION OF ERRORS.

The Court of Appeals erred in the following respects:

1. In holding that a trustee should not be surcharged for profits made by his employees who were permitted to deal in securities of his trust if he was not derelict in hiring them in the first instance.

2. In holding that a trustee should not be surcharged

[1] It is of interest to note that a plan similar to this was followed by Miss Johnson in November of 1936 when she purchased the assets of Jacob Kulp & Company at a bankruptcy sale for $1,500, of which amount Darrow had contributed $750 from trust funds. Part of these assets were accounts receivable alleged to be owed by various of the subsidiary corporations to the bankrupt. Later, these so-called accounts receivable were allowed in the reorganization plans of some of the subsidiaries (R. 218-219, 220-224, 534-538).

for profits made by his employees who were permitted to deal in securities of his trust, if the trustee himself made no profit therefrom.

3. In holding that a trustee should not be surcharged for profits he permitted his employees to make from the sale of such securities to him.

4. In holding that a trustee should not be surcharged for profits he permitted his employees to make from the sale of such securities to him, providing he paid no more than the "market price".

5. In holding that a trustee should not be surcharged for profits he permitted his employees to make from sales of such securities to him if the securities increased in value after he acquired them.

6. In holding that Darrow acted with the care of an ordinarily prudent man in the management of his own property.

7. In failing to find that Darrow was negligent and derelict in his duty to properly supervise the conduct of his employees.

8. In failing to find that Darrow was negligent in failing to take action to recover the illegal profits made by his employees.

9. In failing to find that the trust estates suffered losses.

10. In reversing the order of the District Court insofar as it surcharged Darrow with the profits made by his employees.

11. In reversing findings of fact of the special master, concurred in by the District Court, without a showing that such findings were clearly erroneous.

SUMMARY OF ARGUMENT.

1. The Court of Appeals in its decision in this matter has erroneously set aside the concurrent findings of fact of the Special Master and the District Judge, without finding them to be clearly erroneous.

2. A trustee who permits his confidential employees to trade in the securities of his trust violates his fiduciary duty and should be surcharged for the profits realized by such employees.

A. A trustee may not deal in securities o his trust for his own profit.

B. A trustee's key confidential employees cannot deal in securities of the trust for their own profit.

C. A trustee who knowingly permits his employees to gain prohibited profits is liable to surcharge for such profits.

ARGUMENT.

Point I.

The Court of Appeals in Its Decision in This Matter Has Erroneously Set Aside the Concurrent Findings of Fact of the Special Master and the District Judge, Without Finding Them to Be Clearly Erroneous.

In the decision in this case, the Court of Appeals has set aside findings of fact made by the Special Master and concurred in by the District Court, without showing such findings to be clearly erroneous. The Special Master found that:

> "A trustee cannot be said to have exercised due care where he knowingly allows his employees to work for him under conditions where their loyalties must necessarily be divided.
>
> "(1) In this respect, Mr. Darrow was clearly derelict in entering into an agreement with Miss Johnson and Mr. Kulp whereby they were granted permission to continue their securities business, which, as he surely must have known, dealt extensively in the securities of the trusts and their subsidiaries. A reasonably careful and prudent man could hardly fail to recognize the obvious fact that a situation wherein the trusts and their subsidiaries were attempting to retire their indebtedness as rapidly and as inexpensively as possible, and where the employees of the trusts were trafficking in the bonds of the subsidiaries for profit was pregnant with potential conflicts of interest."

and further:

> "It is clear that Mr. Darrow failed to take any action at all upon discovering that his employees were dealing in the underlying securities for profit. On the contrary, the record indicates that he not only ac-

> quiesced in such activity and permitted disloyalty to flourish, but also knowingly purchased securities from them and thereby allowed their infidelity to inflict direct financial loss upon the trusts in many instances." (R. 553-554)

The Court of Appeals rejected this finding by reaching opposite conclusions, as set forth in the following words:

> "If after such employment Darrow was obliged to exercise 'the care of an ordinarily prudent man in the management of his own property,' it is difficult to see why he should be surcharged under the facts disclosed in this case. His supervision of the trust estate would disclose that the debtor trusts were being largely benefited by the fact that he was enabled to purchase from such part time employees at market prices, the securities of their subsidiaries." (R. 685)

By its action, the Court of Appeals has ignored the well-established principle that concurrent findings of fact by a Special Master and District Judge will not be set aside on appeal except for clear mistake or unless the record discloses them to be clearly erroneous (*Crawford* v. *Neal*, 144 U. S. 585; *In re Willoughby*, 95 F. (2d) 932; *Boyce* v. *Chemical Plastics, Inc.*, 175 F. (2d) 839; *Crimmins* v. *Woodson*, 177 F. (2d) 788; Rule 52(a) of Federal Rules of Civil Procedure).

The necessary requisites for setting aside findings of fact are not present in the instant case.

We, therefore, respectfully submit that it was error for the Court of Appeals to set aside the aforesaid findings of the Master concurred in by the District Court.

POINT II.

A Trustee Who Permits His Confidential Employees to Trade in the Securities of His Trust Violates His Fiduciary Duty and Should Be Surcharged for the Profits Realized by Such Employees.

The decision in this case involves a question of fundamental importance in the administration of trusts and of bankruptcy reorganization. The former trustee knowingly permitted Miss Johnson and Kulp, who were his trusted confidential employees holding strategic positions in the administration of the trusts, to deal in securities of their trusts for their own personal gain. When these key employees dealt in the securities associated with the trusts, they thereby breached their fiduciary duty to their employer and to the trusts. Because Trustee Darrow had knowledge of the actions of his employees and acquiesced in such actions, he himself became properly liable to the surcharge imposed upon him by order of the District Court.

A.

A Trustee May Not Deal in Securities of His Trust for His Own Profit.

It is unquestioned that the trustee himself could not have engaged in transactions for his own benefit and profit in the securities of the trust to which he himself owed a fiduciary duty. *Magruder* v. *Drury*, 235 U. S. 106 (1914); *Michaud v. Girod*, 45 U. S. 503 (1846). This concept is applied with particularity to transactions in properties or securities connected with the trust. *Jackson* v. *Smith*, 254 U. S. 586 (1921); *In re The Van Sweringen Company*, 119 F. (2) 231 (C. C. A. 6, 1941); *Irving Trust Co.* v. *Deutsch*, 73 F. (2) 121 (C. C. A. 2, 1934). A trustee may not compete with his beneficiaries or his trust in

the acquisition of securities. *Wooten* v. *Wooten,* 151 F. (2) 147 (C. C. A. 10, 1945).

Although Darrow did not himself deal in the securities of his trust to his own profit he knowingly permitted his confidential and informed employees to undertake dealings in which he himself unquestionably could not have engaged.

B.

A Trustee's Key Confidential Employees Cannot Deal in Securities of the Trust for Their Own Profit.

The facts in this case disclose that Miss Johnson and Kulp were entrusted in large part with the operational and administrative problems of the trust and that they had confidential information with respect to the operation of the trust and its subsidiaries in their possession or available to them. They were permitted to deal in securities of the trusts in their own names or in the name of Colonial, the corporation controlled by them which they operated from the office occupied jointly with the trustee (R. 150). Both Miss Johnson and Kulp were fully informed of the operations of the trust and Miss Johnson participated in a direct and responsible way in the trust's most confidential aspects and operations, such as participating in the determination of prices to be paid for securities, the determination of the terms of plans of reorganization and other responsible functions. The facts in this case make it perfectly clear that the positions of Kulp and Miss Johnson were those of trusted, confidential assistants of the trustee in important key positions with full knowledge of the operations; these facts imposed upon Kulp and Miss Johnson the duty of complete fidelity and undivided loyalty. *Fleishhacker* v. *Blum*, 109 F. (2) 543 (C. C. A. 9, 1940), *Trice* v. *Comstock*, 121 F. 620 (C. C. A. 8, 1903).

It has recently been held by the Superior Court of Delaware that an employee who acts for his own profit upon confidential information derived through his employment is liable for the profits made therefrom even though injury to the employer could not be shown. *Brophy v. Cities Service Co.*, 70 Atl. 2, 5 (Del. Ch. 1949). The court there stated:

> "Public policy will not permit an employee occupying a position of trust and confidence toward his employer to abuse that relation to his own profit, regardless of whether the employer suffers a loss."

Cf. *Governor Clinton Co., Inc. v. Knott*, 120 F. (2d) 149 (C. C. A. 2, 1941), and *In re Frazin & Oppenheim*, 181 Fed. 307 (C. C. A. 2, 1910).

The trading transactions of Kulp and Miss Johnson fall into three patterns:

(a) They intercepted and purchased bonds which were brought to the office of the trustee for sale, paying a price lower than that which they knew the trustee would pay, and the employees then resold these bonds to the trustee on the same day or a short time thereafter at the trustee's higher purchase price (R. 296);

(b) After purchasing bonds which were brought to the office of the trustee for sale, they sold these bonds elsewhere at a profit (R. 275); and

(c) They used funds of the trust, obtained in advance from the trustee, in order to purchase securities of the trust at prices far below those being paid by the trustee for the same securities and then delivered to the trustee a portion of such bonds in order to offset the trust moneys advanced by the trustee to them. These employees then sold the remaining securities elsewhere at a substantial profit to themselves (R. 171-5, 205, 431).

Darrow had full knowledge at all times that his employees were dealing in these securities, and he also knew

that Colonial was controlled by his employees and was buying and selling securities of the trust (R. 203). It is not contended by Darrow that any of these facts with respect to his employees' dealing in the securities of the trust were concealed from or unknown to him and he admits such knowledge.

The opinion of the Court of Appeals below refers to Kulp and Miss Johnson as part time employees (R. 680, 685). This designation obscures the fact that Kulp and Miss Johnson were receiving substantial salaries, were spending all or substantially all of their business time in the office of the trustee or in the buildings owned by the subsidiaries, and were important officials in the administration and operation of the trusts; the record supports the conclusion that Miss Johnson actually dominated many aspects of the affairs of these trusts. Colonial was practically in liquidation at the time of Darrow's appointment (R. 150); the securities business was in the doldrums and Colonial's operations were almost entirely confined to the bonds associated with the trust (R. 150). The employment of Kulp and Miss Johnson by Darrow, instead of interfering with their management of Colonial, really coordinated extremely well with their operation of Colonial. Miss Johnson's position as assistant to the court's trustee endowed her with special status in the eyes of the bondholders, supplied her with confidential data, and even accorded to her a first opportunity to deal for her own benefit with bondholders tendering their securities for sale in Darrow's office.

Furthermore, the fact that Kulp and Miss Johnson had been the promoters of the original enterprise should have alerted the trustee to the especial necessity of maintaining close watch upon them to see that there was no breach by them of their fiduciary responsibility and no action by them in conflict with the proper and effective administration of the reorganization. Kulp and Miss Johnson were

key employees who must themselves observe fiduciary duties to the estate and to the trustee, and the trustee could not sit idly by, with full knowledge of the transactions in which Kulp and Miss Johnson were engaged, and permit his trusted employees to obtain profits which he himself would have been forbidden to take (R. 209-211).

C.

A Trustee Who Knowingly Permits His Employees to Gain Prohibited Profits Is Liable to Surcharge for Such Profits.

Darrow's conduct in permitting his employees to traffic in the securities of the trust and thereby to violate their fiduciary obligations to him and to the trust, was a direct violation of his fiduciary duty as trustee. Darrow's conduct is such as to render him fully liable to surcharge within the general principles of the common law of trusts, as is stated by Scott, Law of Trusts (1939 Ed., Vol. II, Sec. 225.1, pp. 1191-2).

> "*Where the trustee is himself at fault.* The trustee is liable for the acts of an agent employed by him in the administration of the trust if the trustee is himself guilty of a violation of a duty to the beneficiaries. Thus where an agent does an act which, if done by the trustee would constitute a breach of trust, the trustee is liable if he directed or permitted the doing of the act. He is liable if he improperly delegates to an agent the performance of acts which he was under duty personally to perform. He is liable for the act of an agent employed by him in the administration of the trust, if he did not use reasonable care in the selection or retention of the agent. The trustee is liable for acts of the agent if the trustee has failed to exercise proper supervision over the conduct of the agent. He is liable if he unnecessarily entrusts money or securities of the trust or title deeds or other property to an agent, or permits the agent unnecessarily to retain the property, with the result that the agent mis-

appropriates it. He is liable where the agent does an act which if done by the trustee would be in breach of trust, if the trustee approved or acquiesced in or concealed the act of the agent. The trustee is liable if the agent does an act which if done by the trustee would be in breach of trust, if he does not take proper steps to compel the agent to redress the wrong."

The principles of the common law of trusts which specify that a trustee shall be liable for certain prohibited actions of his agents are also clearly set forth in the Restatement of the Law of Trusts, Vol. I, Sec. 225, page 639, as follows:

"Section 225. Liability for Acts of Agents.

(1) Except as stated in Subsection (2), the trustee is not liable to the beneficiary for the acts of agents employed by him in the administration of the trust.

(2) The trustee is liable to the beneficiary for an act of such an agent which if done by the trustee, would constitute a breach of trust, if the trustee

(a) directs or permits the act of the agent; or

(b) delegates to the agent the performance of acts which he was under a duty not to delegate; or

(c) does not use reasonable care in the selection or retention of the agent; or

(d) does not exercise proper supervision over the conduct of the agent; or

(e) approves or acquiesces in or conceals the act of the agent; or

(f) neglects to take proper steps to compel the agent to redress the wrong."

The facts in this case unmistakably bring Trustee Darrow within the category of a trustee who is at fault for permitting his key, confidential employees to gain profits which he himself would be forbidden to take, in at least the following respects:

1. He not only permitted the illegal acts of his employees but collaborated in such acts by purchasing securities from the employees at prices which resulted

in profits to the employees and losses to his trust estate.

2. The trustee did not use reasonable care in the retention of these employees because he knew at all times that his employees were engaged in the acts complained of.

3. The trustee did not exercise proper supervision over the conduct of his employees. Having full knowledge of their acts, it became his duty to require them to discontinue their illegal practices.

4. The trustee approved and acquiesced in the illegal acts of his employees.

5. The trustee failed to take any steps to compel these employees to redress the wrongs done by them.

The Court of Appeals, in reversing the surcharge of the District Court, stated that:

> "In the brief filed on behalf of Darrow it is claimed that the appellee did not in the court below and could not in this court, present a single bankruptcy case which sustains the theory of the trial court in assessing the surcharges against him. Appellee on the other hand cited and discussed a number of such cases going as far back as the English bankruptcy case in 1794, *Ex Parte Belchier* (1 Amb. 217; 27 Eng. reprint 144)."

The Court of Appeals then cited and discussed, in addition to the *Belchier* case, *Speight* v. *Gaunt* (1883), 22 Ch. 727; *Evans* v. *Williams*, 276 F. 650; *In re Marcus*, 2 F. Supp. 524; *In re Portex Oil Co.*, 43 F. Supp. 859, D. C., D. Ore. 1942. In each of these cases the trustee there involved was held not liable to surcharge because the illegal acts of the agents or employees had been concealed from the trustee and he was powerless to prevent the derelictions there involved. Petitioners do not quarrel with these cases. However, Darrow falls in a completely different category. He exhibited supine negligence and, with full knowledge of his employees' repeated breaches of trust, permitted them to continue further to violate their obligations and aided and

abetted their wrongdoing by continued dealings with them. The above cases which protect a trustee who is not negligent cannot absolve a trustee such as Darrow who knowingly permitted acts of misconduct on the part of his confidential employees; and the principles of law which are governing here, and which impose liability upon Darrow, are the principles enunciated in Scott on Trusts, and in the Restatement of the Law of Trusts, cited *supra*, pp. 17-18.

The Court of Appeals also cites, in reversing the order of the District Court, the case of *In re Breger Kosher Sausage Co.*, 129 F. (2) 62. The decision in that case discloses that no attempt was there made to surcharge a trustee for profits made by his employees, as the Court of Appeals apparently erroneously assumes in its opinion in the instant case (R. 688). The decision in the *Breger* case actually held that upon the evidence presented to the Referee the record there was insufficient to charge the trustee for losses incurred in the operation of the bankrupt business or to sustain the charge that the trustee concealed an interest antagonistic to his trust for which he should be surcharged. The evidence did not sustain the charge of an antagonistic interest in the *Breger* case and there were no profits by employees involved in that case. The court in the *Breger* case therefore refused to reverse the findings of the Referee to the effect that the evidence presented did not sustain the charges of improper conduct.

The court stated in the *Breger* case that the "degree of diligence exercised, we think, is a matter for the bankruptcy court to determ ne." This quotation from the *Breger* case is applicable to the present case; the lack of diligence exhibited by Darrow indicated that he is remiss and should be surcharged for his dereliction.

The case most closely analogous on the facts to the instant case is *Carson, Pirie, Scott & Co.* v. *Turner*, 61 F. (2) 693 (C. C. A. 6, 1932). In that case an auctioneer employed by

a trustee in bankruptcy misapplied considerable merchandise over a period of time. The court there held that the compensation paid to the auctioneer should be disallowed in the trustee's account and that the trustee should be surcharged with the value of the goods taken by the auctioneer, so far as ascertainable, because the auctioneer's defalcations were made possible by the negligence of the trustee. In that case the court stated, at page 694:

> "The proper administration of the bankrupt's estate in the interest of creditors required that the trustee exercise reasonable diligence in the performance of his duties. Had he done so, it is inconceivable that he would not have learned of the practices of Paul in appropriating to his own use much of the most valuable merchandise. When evidence of that circumstance was placed in his hands, he inexcusably failed to act. In spite of this, the referee found that he had discharged his duties faithfully and approved his accounts, allowing the man who had misapplied a part of the assets a large fee for his services and allowing the trustee, who negligently failed to perform his duties, the maximum amount authorized under the acts relating to bankruptcy. We find nothing in the record to support the referee's finding that the trustee faithfully performed his duty, and we hold, as a matter of law, that the order approving his accounts based upon such finding is erroneous."

The opinion of the Court of Appeals indicates that that court believed it is necessary for the appellees (petitioners herein) to present a precedent on almost an identical set of facts in order to justify the surcharge order of the District Court. It is submitted that the *Carson, Pirie, Scott* case, which holds a trustee liable for improper acts of his agent which he could have prevented, is directly analogous and is applicable in the instant case. The instant case presents much more compelling reasons for surcharging the trustee than the *Carson, Pirie, Scott* case in that Darrow had full actual knowledge of his employees' wrong-

doing at all times but did nothing to prevent it. It should also be noted that the cases relied upon by the Court of Appeals and referred to in this brief, *supra*, p. 19, stressed the fact that the trustee did not have knowledge of the improper acts by his employees for which a surcharge was sought, and it is implicit in those cases that if the trustee had been aware of his employees' improprieties that a different situation would have been presented. Furthermore, the general principles of law which are clearly set forth in Scott on Trusts and in the Restatement of the Law of Trusts cited *supra*, pp. 17-18, fully support the surcharge order entered by the District Court upon the recommendation of the Special Master.

The situation in the instant case is comparable to that which is contemplated by Justice Learned Hand's comment in the case of *Berner* v. *Equitable Office Bldg. Corporation*, 175 F. (2) 218, 221 (C. A. 2, 1949) as follows:

> "Be that as it may, in the case of ordinary trusts, ~~not only~~ may the trustee not buy in the property for himself, but he may not allow a third person to purchase at a price lower than concealed facts will justify, and he is accountable if he does."

Justice Hand cites in support of the above statement, Scott on Trusts and the Restatement of Trusts.

It is significant that respondent Darrow at no time has cited any case or authority which authorizes a trustee to permit his employee knowingly to traffic in securities of his trust or to violate breaches of fiduciary duty. The Court of Appeals did not demand precedent of Darrow in support of Darrow's position despite the general principle of law which places on the fiduciary the onus of justifying the propriety of his activity and his accounts. A trustee is always held to the highest standard of fidelity and the burden should rest upon him to establish clearly that he has done so. Cf. *Berner* v. *Equitable Office Bldg.*

Corporation, 175 F. (2) 218 (C. A. 2, 1949). A court of equity and bankruptcy has adequate inherent power to protect the integrity of proceedings before it by appropriate remedy. It is imperative in view of the decision of the court of appeals below that this court make it clear that a trustee does not fulfil his obligations to his court and to his trust if he knowingly permits his key employees to trade in securities of his trust and to profit therefrom.

The Court of Appeals in the instant case has departed from those general principles governing the obligations and responsibilities of the fiduciary which have been laid down in various situations by this court in cases such as *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper* v *Litton*, 308 U. S. 295; *American United Mutual Life Ins. Co.* v. *Avon Park*, 311 U. S. 138; and *Woods* v. *City National Bank*, 312 U. S. 262. The District Court in the case of *In re Los Angeles Lumber Products Co.*, 46 F. Supp. 77 follows the principles laid down by this Court in the above cases, stating at page 91:

> "All of these supreme court cases held fiduciaries to strict standard of conduct including officers, directors, controlling stockholders of corporations, bondholders' committees, etc., and make it clear that the equitable powers of a bankruptcy court are sufficient to provide an appropriate remedy for violation of these standards."

As this Court has pointed out in *American United Mutual Life Insurance Company* v. *Avon Park*, 311 U. S. 138, 146:

> "Where investigation * * * discloses the existence of unfair dealing, a breach of fiduciary obligations, profiting from a trust, special benefits for the reorganizers, or the need for protection of investors against the inside few, or of one class of investors from the encroachments of another, the court has inherent power * * * to adjust the remedy to meet the

need.* * * That power is ample for the exigencies of varying situations. It is not dependent upon express statutory provisions. It inheres in the jurisdiction of a court of bankruptcy."

Under the facts of this case it was entirely appropriate to surcharge the trustee for the profits made by his key employees in their dealings in securities of the trust because these prohibited transactions on the part of these employees were countenanced and condoned by him and the trustee thereby violated his obligations of stewardship to his estate. All of the profits made by the employees were prohibited gains whether they were made directly at the expense of the trust through sales made to the trust or by virtue of usurpation of opportunities which the trust might otherwise have had or whether by the use of confidential information obtained in connection with duties performed as employees of the trust. In any of such events such profits were improper and it was an appropriate measure of the liability imposed upon the trustee to surcharge him for the profits which he permitted his key employees to make. It is the trustee to whom the Court is entitled to look for assurance that breaches of fiduciary duty and benefits from conflicting interests shall not be tolerated.

The Court of Appeals in its opinion stressed the fact that the bonds purchased by Darrow from his employees subsequently increased in value. The question of whether or not a trustee has violated his fiduciary duties is to be determined, and measured, by his conduct at the time of the alleged breach of duty. The fact that securities purchased by the trust in connection with improper transactions subsequently increased in value (which increase in value was attributable to general economic conditions and general enhancement in the values of real estate securities) cannot absolve the trustee, restrospectively, from liability

for his earlier failures to carry out his fiduciary responsibilities and to prevent his employees from violating their fiduciary duties. Subsequent enhancement is no defense to a surcharge, because if the trustee's acts were unlawful "it makes no difference that the estate was not the loser in the transaction." *Magruder* v. *Drury,* 235 U. S. 106. The trust was entitled to buy the bonds at the lowest price available which was the price paid by Kulp, Johnson or Colonial without adding any profit to them.

Even if the estate had suffered no loss in the transactions involved, which the Special Master found was not the case (R. 554), that fact would still not insulate from liability a trustee who had been derelict in his fiduciary duty. This principle is clearly pointed out in the case of *Magruder* v. *Drury,* 235 U. S. 106. The Court held in the *Magruder* case that the trustee was responsible to the estate for brokerage profits which his brokerage firm had made, without regard to the fact that like brokerage commissions would have been paid to any other brokerage firm which handled the transaction. The Court there indicated that it made no difference whether or not the estate was a loser by the method in which the transaction was consummated; the transaction by the fiduciary was forbidden without regard to gain or loss and a surcharge measured by such profits was an appropriate measure of liability.

The opinion of the Court of Appeals states that the activities of Darrow in the acquisition of the securities of Federal and National and their subsidiaries resulted in substantial benefits to the estates (R. 685). This fact, even if it were true, would not be determinative of the issue of dereliction of duty. Moreover, the bulk of the securities purchased by the trustee or retired during his administration, as referred to in the opinion of the Court of Appeals (R. 680-81), were purchased through sinking funds created by the subsidiaries pursuant to plans of reorganizations.

Even if the estate had sustained profits which might be ascribed to Darrow or his employees, such fact would not furnish a defense to the consequences of Darrow's supine negligence in permitting Kulp and Miss Johnson to engage in transactions in securities associated with their trust at profit to themselves. It should also be noted, in speaking of alleged benefit to the estate, that trustee Darrow countenanced the acquisition by Kulp and Miss Johnson of substantial amounts of securities of National and Federal through the sale in *Seligman* v. *Kulp*, and that the attempt of these employees to acquire these securities may involve control of both Federal and National and may result in great detriment to the holders of securities whom Darrow was bound to protect.

Statements of the reasons for the prohibition of dealings by fiduciaries with their beneficiaries or their trusts are found in many situations involving liability of such fiduciaries for proscribed dealings; even though the factual situations in such cases are not on all fours with the present case the general statements of law with respect to fiduciary liability are applicable here as well as in the cases where they are stated. In the case of *Winger* v. *Chicago City Bank & Trust Co.*, 394 Ill. 94 (1946) the Supreme Court of Illinois in setting aside a transaction between corporate directors and their corporations said, page 114:

> "In case of constructive fraud by the officers of a corporation, where they deal for themselves and at the same time act for the corporation, it is immaterial whether the contract is fair or unfair, or whether there is good or bad faith, and it may be set aside because of the relationship of the parties."

The Illinois court also makes an extensive review of English and American cases enunciating the inexorable rule that a trustee may not deal with his trust regardless

of the terms of the dealing, quoting, among others, the excellent statement of Lord Cranworth in *Hughes* v. *Watson*, Scotland (1846) to the effect that:

> "It may sometimes happen that the terms in which the trustee has dealt, or attempted to deal, with the estate or interests of those for whom he is trustee, may have been as good as could have been obtained from any other person—they may even at the time have been better; but still so inflexible is the rule that no inquiry on the subject is permitted."

The general principles of trust law, applicable also to the instant situation with respect to the immateriality of whether or not the estate suffered a loss, are also set forth in the case of *Pelcak* v. *Bartos*, 328 Ill. App. 435, in which the Court surcharged a trustee of a charitable society for the commissions, as a licensed bond dealer, which he had secretly obtained, stating that:

> "But even if it be assumed, as Cipra contends, that there was no increase in cost, that the society did not overpay for these securities and that it suffered no loss or injury, nevertheless, by reason of his fiduciary relationship and trust, he would still be accountable to the society for any secret personal profit made by him"

Similarly, in the case of *White* v. *Sherman*, 168 Ill. 589 (1897) the Court stated the reason for this general rule as follows:

> "The law does not allow a trustee to retain any personal gain, which he may obtain in such a manner as subjects him to the temptation of placing himself in a position which may be hostile to the interests of the estate, whether the estate is actually injured or not as a matter of fact. The fact, that he was receiving commissions might have subjected him to a temptation to place a larger line of insurance than was necessary on the trust property. It is not essential that the estate has suffered a loss from what he has

done; it is sufficient that he has gained a profit. Whether the contract was beneficial or injurious to the estate is wholly immaterial."

Since Trustee Darrow in the instant case permitted his key employees, who were themselves fiduciaries, to make proscribed profits which he as a trustee should have prevented them from making with full knowledge of all of the pertinent facts, he is himself chargeable with the consequences of his own act in failing to take the proper actions encumbent upon him.

The decision of the Court below also stresses the fact that the securities which Darrow purchased from Miss Johnson or Colonial were purchased at "market." In the light of the cases just cited, this fact in itself would be immaterial. It should also be noted that the so-called market of these securities was an extremely artificial one because of the restricted extent of such market, because the so-called market price was fixed by Darrow and Miss Johnson (R. 211), and because Colonial played a central role in the so-called market (R. 160-1).

The Court of Appeals in its opinion (R. 685) indicates that it considers that Darrow acted as an ordinary prudent man. A trustee cannot traffic in the assets of his trust for his own gain nor can his employees do so. Consequently a trustee cannot be said to exercise the care of an ordinary prudent man in knowingly permitting his confidential employees to carry on transactions which both he and his employees are forbidden to do and in aiding and abetting them in their improper transactions.

CONCLUSION.

In conclusion, we respectfully submit that the Court of Appeals has in effect held by its decision in this case that a court of equity and bankruptcy is without the power to deal with its own appointed trustee who not only permitted and assisted his key confidential employees, who were themselves fiduciaries, in violating their fiduciary duties to him and the estate. Such a decision imposes a novel and unwarranted limitation upon the inherent powers of a court of equity and bankruptcy in safeguarding a trust estate. Furthermore, such a decision fails to recognize the "uncompromising rigidity" which has heretofore been the "attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions." *Meinhard* v. *Salmon*, 249 N. Y. 458.

The decision of the Court of Appeals, if permitted to stand, will deprive a court of equity and bankruptcy of the normal, and the only effective, sanction against the pernicious practice of permitting confidential employees of a trustee to profit by dealing in the securities of the trust. The decision of the Court of Appeals, if permited to stand, will undermine the high standards of ethics and the inexorable rules of unswerving devotion which have heretofore governed the conduct of fiduciaries in the administration of trusts and reorganizations. The decision of the Court of Appeals, if permitted to stand, will permit a trustee knowingly to allow his key employees to take improper and gainful advantage of their confidential fiduciary positions and would absolve such a delinquent trustee, to whom courts and beneficiaries are entitled to look for active stewardship and ultimate responsibility, from the blame and liability which such a trustee should bear.

It is therefore respectfully submitted that this Court should reverse the decision of the Court of Appeals for the Seventh Circuit in this case and sustain the surcharge imposed by the District Court.

Respectfully submitted,

Carl W. Mulfinger,
J. Edgar Kelly,
Stanley A. Kaplan,
Jacob A. Courshon,
Counsel for Petitioners.